No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. and REICH & TANG, INC.,
Petitioners,

—v.—

MARTIN FOX,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' BRIEF

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April 21, 1983

Question Presented for Review

Is a shareholder's derivative action under § 36(b) of the Investment Company Act of 1940 exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure?

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Opinions Below

The opinion of the District Court (Hon. Kevin T. Duffy) is reported at 94 F.R.D. 94 (S.D.N.Y. 1982). The opinion of the Court of Appeals is reported at 692 F.2d 250 (2d Cir. 1982).

Jurisdiction

The judgment of the Court of Appeals was entered on October 26, 1982. A petition for a writ of certiorari was filed on January 17, 1983 and granted on March 7, 1983. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

Statutes and Rules Involved

The statutes and rules involved are § 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. § 80a-35(b), and Rule 23.1 of the Federal Rules of Civil Procedure ("Rule 23.1").

Statement of the Case

Respondent, a minority shareholder of Daily Income Fund, Inc. ("the Fund"), a money market fund, instituted a derivative action under § 36(b) of the ICA on behalf of the Fund against Reich & Tang, Inc. ("the Adviser"), the investment adviser to the Fund, for allegedly excessive advisory fees. The Fund was also named as a defendant.

The Board of Directors of the Fund consists of five individuals: three unaffiliated directors and two who are affiliated with the Adviser. Thus, a majority of the Board of Directors of the Fund is unaffiliated.[1]

No demand was made by respondent on the directors to obtain the relief he desired. Respondent simply took matters into his own hands and, without advance notice, commenced litigation, allegedly on behalf of the Fund, in violation of the director demand requirement of Rule 23.1.

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1 The unaffiliated directors are: W. Giles Mellon, Professor of Business Administration in the Graduate School of Business Administration, Rutgers University; Alan J. Patricof, head of a private investment corporation and Dr. Yung Wong, managing Director of a venture capital investment firm. The affiliated directors are: Joseph H. Reich, President and Treasurer of the Fund, and Oscar L. Tang, Chairman of the Board and Secretary of the Fund.

The Fund promptly moved to dismiss the action for failure by respondent to comply with the director demand requirement of Rule 23.1, and that motion was granted by the District Court (11-22a). The District Court reasoned, based on a thorough review of the legislative history of the ICA, that ". . . under the statutory mandate the board of directors of an investment company is to be the first line of defense for the individual investor against any self dealing into which an adviser might be tempted." (15a). The District Court therefore held that ". . . a Rule 23.1 demand is a *sine qua non* in this type of litigation." (15a).

On appeal, the Court of Appeals reversed, holding that the director demand requirement of Rule 23.1 does not apply to a shareholder's action under § 36(b) (23-49a). The Court reasoned that a § 36(b) action is not "strictly speaking" derivative because an investment company does not itself possess the right to bring an action against its adviser for return of allegedly excess fees (28-46a). The Court of Appeals also reasoned that the director demand requirement is inconsistent with the operation of § 36(b) (46-48a).

Summary of Argument

The Court of Appeals erred in holding that a shareholder's derivative action under § 36(b) of the ICA is exempt from the director demand requirement of Rule 23.1.

The language and legislative history of § 36(b) demonstrate that a shareholder's derivative action brought thereunder must satisfy the director demand requirement of Rule 23.1. Indeed, to allow a shareholder to bypass the

board of directors of an investment company and bring a § 36(b) action, without consultation, would undermine the oversight role of the directors by denying them the opportunity to resolve the shareholder's grievance without litigation.

The Court of Appeals, however, held that Rule 23.1 does not apply to a shareholder's derivative action under § 36(b) because investment companies do not, themselves, have a right of action under § 36(b) and a shareholder's action is therefore not "strictly speaking" derivative. Both premises of that holding are incorrect—an investment company does have a right of action under § 36(b), and, even if it did not, a shareholder's action to recover allegedly excessive advisory fees is, in any event, derivative because it is brought on behalf of the company. Accordingly, Rule 23.1 applies to such an action.

The Court of Appeals also erred in holding that application of the director demand requirement to a shareholder's derivative action under § 36(b) would conflict with the operation of § 36(b). Neither the possible limitations on the ability of the directors to cut off a § 36(b) action nor the one-year limitation on recovery is inconsistent with the application of the director demand requirement to § 36(b) actions.

The result reached by the Court of Appeals ignores the important role envisioned by Congress for directors and permits institution of unchecked litigation that may well be contrary to the best interests of all the shareholders of an investment company—as such, it cannot be reconciled with the logic of this Court's opinion in *Burks* v. *Lasker*, 441 U.S. 471 (1979).

Point I

A shareholder's derivative action under § 36(b) of the Investment Company Act of 1940 is not exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure.

The language of § 36(b) itself demonstrates that a shareholder's action thereunder is derivative and, accordingly, a shareholder plaintiff must satisfy the director demand requirement of Rule 23.1.

§ 36(b) states, in pertinent part, that "[a]n action may be brought under this subsection . . . by a security holder of such registered investment company *on behalf of* such company. . ." (emphasis supplied). Such an action is, by definition, a derivative action. In *Burks* v. *Lasker,* 441 U.S. 471, 477 (1979), this Court stated: "A derivative suit is brought by shareholders to enforce a claim *on behalf of* the corporation." (emphasis supplied).[2] Indeed, this Court went on, in *Burks,* to refer specifically to § 36(b) actions as "derivative." 441 U.S. at 484. Accordingly, the director demand requirement of Rule 23.1 applies to § 36(b) actions, as it does to all other derivative actions in the federal courts.

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2 The Court of Appeals erroneously held that the "on behalf of" language in § 36(b) does not make a shareholder's action thereunder derivative, "but rather constitutes individual security holders as 'private attorneys general' to assist in the enforcement of a duty imposed by the statute on investment advisers." *Fox* v. *Reich & Tang, Inc., supra,* 692 F.2d at 255. No citation of authority whatsoever is offered by the Court of Appeals for this novel conclusion, and it conflicts with this Court's view in *Burks*, quoted above, that an action brought by a shareholder on behalf of a corporation is a derivative action.

The legislative history of § 36(b) confirms that Congress did not intend to exempt such actions from the scope of Rule 23.1. To the contrary, the legislative history, as interpreted by this Court in *Burks*, clearly shows that Congress, in the 1970 amendments to the ICA, intended to further the policies of corporate self-governance and the exhaustion of intracorporate remedies, both of which underlie the director demand requirement of Rule 23.1.[3]

The Senate Report, which is the basic document in the legislative history of § 36(b), states:

> "These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary."

S. Rep. No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Admin. News 4897, 4902-03.

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3 The Court of Appeals dwelt at length on the fact that the legislative history of the 1970 amendments also showed concern with the prior ineffectiveness of the independent directors with respect to advisory fees and the need for increasing the role of courts in this area. *Fox* v. *Reich & Tang, Inc., supra*, 692 F.2d at 256-61. However, as the Court of Appeals for the First Circuit held in *Grossman* v. *Johnson*, 674 F.2d 115, 122 (1st Cir.), *cert. denied*, ___ U.S. ___, 103 S.Ct. 85 (1982), "these themes are all fully consistent with the continued operation of the demand part of Rule 23.1, which would not impede or contradict any of the stated purposes."

Thus, as this Court recognized in *Burks* v. *Lasker, supra,* 441 U.S. at 484-85:

> "In short, the structure and purpose of the ICA indicate that Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders." (footnote omitted)

Allowing a shareholder to bypass the board of directors and bring a § 36(b) action without even making a demand upon the directors is inconsistent with that purpose. The Court of Appeals for the Third Circuit stated in *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928, 942 (3d Cir. 1982):

> "The ICA and its amendments were designed to erase potential conflicts of interest inherent in the structure of investment companies by placing the unaffiliated directors in a substantial management role and providing them with authority to act as checks on advisory fees. Congress explicitly empowered the directors to redress challenges to advisory fees by imposing on directors a duty to evaluate the advisory fees and by authorizing them to terminate investment adviser contracts without penalty upon the giving of sixty days notice. 15 U.S.C. § 80a-15(a)(3) (1976). To allow shareholders to bypass the directors would undermine the role shaped for directors by the ICA." (footnote omitted).

See also *Fox* v. *Reich & Tang, Inc., supra,* 94 F.R.D. at 97; *Lerman* v. *ITB Management Corp.*, 58 F.R.D. 153, 158 (D. Mass. 1973).

Moreover, the legislative history of the 1970 amendments also demonstrates a concern to discourage unjusti-

fied derivative actions and to do so specifically through the application of the Federal Rules of Civil Procedure. In response to a question as to whether permitting a shareholder to challenge advisory fee contracts would lead to unfounded litigation, SEC Chairman Hamer H. Budge responded as follows:

> "We do not believe that this would leave the door wide open to nuisance actions. As we have pointed out previously, there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation."

Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. at 201 (1969). Later in his testimony, Mr. Budge again stated that the problem of "strike suits" could be adequately dealt with by the Federal Rules of Civil Procedure:

> "There are already in H.R. 11995 and in the FRCP[12] sufficient safeguards against frivolous or harassing lawsuits.
>
> 12 See e.g., Rule 23 FRCP."[4]

Id. at 860.

In sum, as the Court of Appeals for the Third Circuit concluded in *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 938:

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[4] Although the citation in Mr. Budge's testimony is to Rule 23, he seems clearly to have intended to refer to Rule 23.1. *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 938; *Grossman* v. *Johnson, supra,* 674 F.2d at 122.

"... the legislative history reflects an implicit understanding that Rule 23.1 would apply—an understanding which comports with the purposes of section 36(b)."

See also *Grossman* v. *Johnson, supra,* 674 F.2d at 122.

Point II

The Court of Appeals erred in holding that a shareholder's action under § 36(b) is not a derivative action.

At the heart of the decision of the Court of Appeals is its holding that a shareholder's action under § 36(b) is not "strictly speaking"[5] derivative—and thus Rule 23.1 does not apply—because an investment company does not itself possess the right to bring an action against its adviser for return of allegedly excessive fees. There are two errors in that holding: first, an investment company does have an implied right of action under § 36(b); and second, even if it does not, a shareholder's action is nevertheless derivative and, accordingly, Rule 23.1 applies to such an action.

A. An investment company has an implied right of action under § 36(b)

The holding of the Court of Appeals that an investment company cannot sue its adviser to recover allegedly excessive fees ignores this Court's decisions as to the applicable framework for determining whether a statute creates an

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5 The Court of Appeals, in order to support its result, erroneously conjured up a new form of shareholder's action, one that both is and is not derivative. This construct is unsupported in law and renders the entire analysis of the Court of Appeals faulty.

implied right of action and misreads the legislative history of § 36(b).

In *Cort* v. *Ash*, 422 U.S. 66, 78 (1975), this Court set forth the four factors that should be considered on the issue of a statutory implied right of action. All of these factors favor recognition of a right of action under § 36(b) in an investment company.

First, it is clear that § 36(b) was enacted for the benefit of investment companies. The fiduciary duty imposed on advisers is owed to the company itself, S. Rep. No. 184, *supra*, 1970 U.S. Code Cong. & Admin. News at 4902, and any recovery obtained in a § 36(b) action will go to the investment company rather then the plaintiff.

Second, such evidence of legislative intent as there is favors recognition of the right of an investment company to bring a § 36(b) action. At the time of the 1970 amendments to the ICA, it was well established that an action by a shareholder of an investment company for breach of fiduciary duty was derivative. The common law predecessor to a § 36(b) action was a shareholder's action against the adviser for "corporate waste," which was derivative. E.g., *Smith* v. *Sperling*, 354 U.S. 91 (1957); *Saxe* v. *Brady*, 184 A.2d 602 (Del. Ch. 1962); 13 W. Fletcher, Cyclopedia of the Law of Private Corporations ¶¶ 5924, 5926-27 (rev. perm. ed. 1980). Similarly, a shareholder's implied right of action under former § 36 of the ICA (now § 36(a)) to recover excessive advisory fees was uniformly held to be derivative. E.g. *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971); *Kauffman* v. *Dreyfus Fund, Inc.*, 434 F.2d 727, 732-33 (3rd Cir. 1970); *Brown* v. *Bullock*, 194 F. Supp. 207, 245 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

In light of this background, Congress can and should be presumed to have known in 1970 that an investment company had its own right of action against its adviser. *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran,* 456 U.S. 353, 102 S. Ct. 1825, 1841 n. 66 (1982). Since there is no evidence whatsoever that Congress intended to abolish this pre-existing right of an investment company to bring an action to recover excessive advisory fees, the Court of Appeals erred in holding that an investment company has no right of action under § 36(b). See *Herman & MacLean* v. *Huddleston,* ____ U.S. ____, 103 S.Ct. 683, 689 (1983); *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran, supra,* 102 S. Ct. at 1839; *Cannon* v. *University of Chicago,* 441 U.S. 677, 695-99 (1979).

Even if the state of law at the time of the 1970 amendments to the ICA were not conclusive, Congress' silence would still favor recognition of an implied right of action in an investment company under § 36(b). As this Court recognized in *Cannon* v. *University of Chicago, supra,* 441 U.S. at 694:

> ". . . the legislative history of a statute that does not expressly create or deny a private remedy will typically be silent or ambiguous on the question. Therefore, in situations such as the present one 'in which it is clear that federal law has granted a class of persons certain rights, it is not necessary to show an intention to *create* a private cause of action, although an explicit purpose to *deny* such cause of action would be controlling.' *Cort,* 422 U.S. at 82, 45 L. Ed. 2d 26, 95 S. Ct. 2080 (emphasis in original)."

Since § 36(b) clearly grants to investment companies the right *not* to be charged excessive advisory fees, it is not necessary, in order for this Court to recognize the exist-

ence of a right of action under § 36(b) in an investment company, to show a clear Congressional intent to *create* such a right of action; it is sufficient that there is no evidence of Congressional intent to *deny* such a right of action. The Court of Appeals therefore erred in construing Congress' silence as evidence against an investment company's right of action under § 36(b).

Third, an investment company's right to bring a § 36(b) action accords with the purposes of the ICA by providing another remedy for the recovery of excessive advisory fees and by allowing the directors of the investment company to perform their role as "watchdogs."

Fourth, since § 36(b) has already federalized this type of litigation, the implication of a right of action in an investment company would not intrude on an area traditionally relegated to state law.

The Court of Appeals for the Third Circuit analyzed the *Cort* factors at length in *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 935-36, and concluded (as we have just argued) that an investment company has a right of action against its adviser for a breach of the fiduciary duty imposed by § 36(b). See also *Grossman* v. *Johnson, supra,* 674 F.2d at 120; *Markowitz* v. *Brody,* 90 F.R.D. 542, 557 n. 12 (S.D.N.Y. 1981).

By contrast, the Court of Appeals in this case did not specifically evaluate any of these factors. Although it recognized that the legislative history of § 36(b) was silent as to whether an investment company could bring an action to recover excessive advisory fees, it construed that silence as militating against an implied right of action. Its rationale for that conclusion was that "[t]he relationship of a fund to its adviser makes it part of the problem in a

way that precludes it from being part of the solution, at least at the litigation stage." *Fox* v. *Reich & Tang, Inc.*, *supra*, 692 F.2d at 260. That conclusion is based upon a presumption of directorial hostility to § 36(b) actions. Such a presumption conflicts with the statutory scheme of the ICA and this Court's decision in *Burks* v. *Lasker, supra*, 441 U.S. at 482-85. As this Court stated in *Burks,* 441 U.S. at 485 n.15:

> "While lack of impartiality may or may not be true as a matter of fact in individual cases, it is not a conclusion of law required by the Investment Company Act. Congress surely would not have entrusted such critical functions as approval of advisory contracts and selection of accountants to the statutorily disinterested directors had it shared the Court of Appeals' view that such directors could never be 'disinterested' where their codirectors or investment advisers were concerned."

To deny the directors an opportunity to consider a shareholder's claim of excessive advisory fees would undercut the whole Congressional effort to enhance the role of unaffiliated directors. Although *Burks* dealt with a different ultimate issue, it aptly appraised the role Congress assigned to the unaffiliated directors in the 1970 amendments to the ICA:

> "Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholders interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled." (footnote omitted)

Burks v. *Lasker, supra*, 441 U.S. at 485. Thus, an implied corporate right of action under § 36(b) is not at all

inconsistent with the purpose of the ICA. To the contrary, it furthers the role of the directors as "watchdogs" and provides another means (in addition to suits by the SEC and shareholders) to police advisory fees.

B. Even if an investment company does not have a right of action under § 36(b), a shareholder's action is nevertheless derivative and must satisfy the director demand requirement of Rule 23.1

Even if (contrary to our analysis) an investment company does not itself have a right of action under § 36(b), a shareholder's action under § 36(b) is nevertheless derivative and must be preceded by a director demand.

Since a shareholder's action under § 36(b) is brought "on behalf of" the investment company and any recovery goes to the investment company, not the plaintiff, a shareholder's action under § 36(b) is necessarily derivative. *Burks* v. *Lasker, supra*, 441 U.S. at 484.[6]

The Court of Appeals, notwithstanding this authority, held that Rule 23.1 "applies only when the specified entity has an opportunity to assert, in a court, the same action under the same rule of law on which the plaintiff share-

6 It is also noteworthy that the lower courts have routinely treated a shareholder's action under § 36(b) as derivative in other respects as well by requiring court approval of a proposed settlement, by awarding attorney's fees to successful plaintiffs out of the amount recovered on behalf of an investment company, and by treating a settlement of a shareholder's § 36(b) action as precluding any other actions by shareholders challenging the same advisory fee. *E.g.*, *Markowitz* v. *Money-market Assets, Inc.*, [1981-1982] CCH Fed.Sec.L.Rep. ¶ 98,360 (S.D.N.Y. 1981); *Krasner* v. *Dreyfus Corp.*, 500 F. Supp. 36 (S.D.N.Y. 1980), 90 F.R.D. 665 (S.D.N.Y. 1981); *Lerner* v. *Reserve Management Co.*, [1981] CCH Fed.Sec.L.Rep. ¶ 98,036 (S.D.N.Y. 1981).

holder relies." *Fox* v. *Reich & Tang, Inc., supra,* 692 F.2d at 254. That holding finds no support in the language of Rule 23.1 which requires director demand in a derivative action brought by a shareholder "to enforce a right of a corporation . . . , the corporation . . . having failed to enforce a right which may properly be asserted by it. . . ." Thus, by its terms, Rule 23.1 applies whenever a shareholder seeks to enforce a right of a corporation which the corporation could assert; it does not require that the corporation's right must give rise to the same action under the same rule of law on which the shareholder relies.

In support of its restrictive interpretation of Rule 23.1, the Court of Appeals relied on this Court's reference in *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co.*, 213 U.S. 435, 447 (1909) to a derivative action as one "founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff." That language is inapposite.

In *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co., supra,* this Court did not purport to define a derivative action; it merely set forth one of the prerequisites to the maintenance ot an action by a shareholder in the name of the corporation—i.e. that the corporation have a right of action of its own. Nor did this Court state in *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co., supra* that in order for an action to be derivative, the corporation's right of action and the rule of law on which it is based must be identical to those upon which the shareholder relies. And in *Ross* v. *Bernhard,* 396 U.S. 531, 534 (1970), this Court stated merely that one of the prerequisites for a shareholder's action "was a valid claim on which the corporation could have sued. . . ."

Quite apart from the issue of whether an investment company can sue under § 36(b), it has a valid claim

against its investment adviser to recover excessive fees and can enforce that claim by means of an action under state law. See, e.g., *Llewellyn* v. *Queen City Dairy, Inc.*, 48 A.2d 322, 326 (Md. 1946).

Moreover, the purposes of the director demand requirement of Rule 23.1 are applicable to a shareholder's action under § 36(b) regardless of whether the investment company can itself bring such an action. Over 100 years ago in *Hawes* v. *Oakland*, 104 U.S. 450, 460-61 (1882),[7] this Court recognized that:

> ". . . before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the Court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances or action in conformity with his wishes."

By providing a corporation with an opportunity to "vindicate its own rights," *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 548 (1949), the director demand requirement serves several important purposes. The director demand requirement "furthers a principle basic to corporate organization, that the management of the corporation be entrusted to its board of directors." Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171

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7 During the same term this Court adopted Equity Rule 94 to implement that decision. The director demand requirement was later embodied in Equity Rule 27 and was incorporated in Rule 23(b) and then Rule 23.1 of the Federal Rules of Civil Procedure.

(1976). As the Court stated in *Heit* v. *Baird*, 567 F.2d 1157, 1162 n. 6 (1st Cir. 1977):

> "The purpose of the demand requirement is, of course, to require resort to the body legally charged with conduct of the company's affairs before licensing suit in the company's name by persons not so charged. Given the expense of litigation, and the normal presumption running in favor by those acting for the company, this seems only reasonable."

In addition, the director demand requirement performs several practical functions. It "enables corporate management to pursue alternative remedies, thus often ending unnecessary litigation." *Cramer* v. *General Telephone & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129 (1979). It also serves "to afford corporate directors reasonable protection from harassment by litigious dissident shareholders, and thus to discourage strike suits by shareholders making reckless charges for personal gain rather than corporate benefit." *Markowitz* v. *Brody, supra*, 90 F.R.D. at 561. And by requiring exhaustion of intracorporate remedies, the director demand requirement serves to "foster amicable resolution of differences." *Lerman* v. *ITB Management Corp., supra*, 58 F.R.D. at 157-58.

As was well summarized in *Mills* v. *Esmark Inc.*, 91 F.R.D. 70, 72 (N.D. Ill. 1981):

> "The purpose of the demand requirement of Rule 23.1 is to allow a corporation to activate intracorporate remedies to address shareholder complaints prior to resorting to judicial intervention. . . . In theory, this salutary policy inures to the benefit of all involved. The dissident shareholder is provided with

> an opportunity to achieve his goal without incurring the expense of litigation; the directors of the corporation are allowed to occupy their status as managers of the corporation's affairs; the corporation is left to clean its own house, free from judicial entanglements; and the courts are relieved of the burden of prematurely resolving intracorporate disputes. Of course, it is also possible, indeed likely, that the corporation will refuse to take the action demanded by the shareholder. The purpose of Rule 23.1, however, is to give the corporation a fair opportunity to act on the demand, short of litigation." (citation omitted)

These policies have particularly clear application to a shareholder's derivative action under § 36(b) because of the special oversight role in advisory fees which Congress gave to the unaffiliated directors of an investment company. To exempt § 36(b) actions from the director demand requirement of Rule 23.1 would allow a single shareholder to bypass the duly elected directors and force an investment company into expensive and time-consuming litigation. In this era of burgeoning caseloads, the director demand requirement is a particularly important protection against possibly unjustified litigation.

Faced with a timely demand, the directors can respond in a number of ways short of litigation. If the directors find the claim has merit, they can negotiate with the adviser to obtain a return of fees and/or terminate the contract if the adviser refuses. If the directors find the claim lacks merit, they might nevertheless succeed in avoiding litigation by convincing the complaining shareholder that the fees are reasonable or that litigation would adversely affect all shareholders' interests. See *Weiss* v.

Temporary Income Fund, Inc., *supra*, 692 F.2d at 942 n.16; *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 91 F.R.D. 524, 526 (S.D.N.Y. 1981); *Markowitz* v. *Brody, supra*, 90 F.R.D. at 560-61; *Untermeyer* v. *Fidelity Daily Income Trust*, 79 F.R.D. 36, 46 (D. Mass. 1978).

The Court of Appeals in this case gave no weight to these other remedies because of its belief that, as a practical matter, they would not be effective. *Fox* v. *Reich & Tang, Inc.*, *supra*, 692 F.2d at 254 n. 7. That belief is unsupported and conflicts with the whole purpose of the ICA to make the unaffiliated directors the "independent watchdogs" of an investment company's interests. *Burks* v. *Lasker, supra*, 441 U.S. at 484.

In sum, the central premise of the Court of Appeals' decision is erroneous: an investment company has its own right of action under § 36(b), and even if it does not, a shareholder's action under § 36(b) is derivative and must comply with the director demand requirement of Rule 23.1.

Point III

The Court of Appeals erred in holding that the director demand requirement is inconsistent with the operation of § 36(b).

As a minor theme, the Court of Appeals in this case also held that the application of the director demand requirement to a shareholder's action under § 36(b) is inconsistent with the operation of the ICA because of (1) the possible limitations on the ability of the directors to cut off a § 36(b) action and (2) the one-year limitation to recovery under § 36(b). This holding is also erroneous.

Before turning to the particular flaws in this holding, it should be noted that it conflicts with the general presumption that Rule 23.1, like all of the Federal Rules of Civil Procedure, applies to civil actions in federal district courts unless inconsistent with a statute. See Rule 1, Federal Rules of Civil Procedure. As the Court of Appeals for the Third Circuit stated:

> "Abrogation of a rule of procedure generally is inappropriate '[i]n the absence of a direct expression by Congress of its intent to depart from the usual course of trying "all suits of a civil nature" under the Rules established for that purpose.' *Califano* v. *Yamasaki,* 442 U.S. 682, 683, 700, 99 S.Ct. 2545, 2557, 61 L.Ed.2d 176 (1979). Repugnancy of a statute to a civil rule is not to be lightly implied. Rather, 'a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible.' *Grossman* v. *Johnson, supra,* 674 F.2d at 122-23 (quoting 7 Moore's Federal Practice ¶ 86.04[4] at 86-22 (2d ed. 1980)); accord *Fox* v. *Reich & Tang, Inc.,* 94 F.R.D. 94 (S.D.N.Y. 1982), rev'd on other grounds, 692 F.2d 250 (2d Cir. 1982)."

Weiss v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 936.

As demonstrated above, the legislative history of § 36(b) provides no evidence whatsoever of a Congressional intent to exempt a shareholder's action from the director demand requirement. As the Court of Appeals for the First Circuit held in *Grossman* v. *Johnson, supra,* 674 F.2d at 121:

> ". . . there is no persuasive indication that, in adopting section 36(b) Congress wished to repeal or limit the demand provision of Rule 23.1 which has

long been a general part of our federal law of practice and procedure, governing almost all derivative actions in federal courts."

To the contrary, the evidence indicates that Congress intended to afford the directors the opportunity to fulfill their oversight role with respect to advisory fees. Eliminating the demand requirement would be inconsistent with this legislative intent. Neither the possible limitations on the ability of the directors to cut off a § 36(b) action nor the one-year limitation on recovery of damages compels a contrary conclusion.

A. The possible limitations on the ability of the directors to cut off a § 36(b) action do not make the director demand requirement inapplicable.

In *Burks* v. *Lasker, supra,* 441 U.S. at 484, this Court, in dictum, suggested that § 36(b) deprives the directors of their authority to cut off a shareholder's action thereunder.[8] Based on that suggestion, the Court of Appeals below held that the traditional reason for the demand requirement does not apply—i.e., if the directors are considered too "interested" to be permitted to cut off a § 36 action, they must also be considered so "interested" as to make a demand futile. *Fox* v. *Reich & Tang, Inc., supra,* 692 F.2d at 261 & n. 13;[9] see also *Weiss* v.

8 The ability or inability of directors to cut off (i.e. prevent or terminate) a § 36(b) action remains an open question that need not be decided by this Court to resolve the issue posed by this case.

9 In concluding that the traditional reasons for director demand do not apply in § 36(b) actions, the Court of Appeals also relied on the fact that "shareholder plaintiffs are necessarily challenging fees the directors evaluated and approved . . ."

Temporary Investment Fund, Inc., supra, 692 F.2d at 945-46, 952-53 (dissenting opinion of Gibbons, J.).

This conclusion is based on an overly narrow view of the function of the director demand requirement. That requirement is not merely a procedural advice for implementing the business judgment rule; rather as demonstrated above, it is based on a policy favoring exhaustion of intracorporate remedies which has vitality even if the directors cannot cut off a § 36(b) action. As the Court of Appeals for the First Circuit held in *Grossman* v. *Johnson, supra,* 674 F.2d at 121:

> "Nevertheless, even on that interpretation of the statute [i.e. that the directors cannot cut off shareholder's action under § 36(b)], a demand would not be futile. It would give the independent directors the opportunity to study the problem and decide whether to accede, in whole or in part, to the complainant's views. When it added § 36(b), Congress also deliberately strengthened the position of independent directors, including their dealing with advisory fees. See *Burks* v. *Lasker, supra,* 441 U.S. at 482-485, 99 S.Ct. at 1839, 1840-1941. They were not designed to be ciphers or to be overlooked. Although the court would decide for itself (on the view we accept *ar-*

Fox v. *Reich & Tang, Inc., supra,* 692 F.2d at 261. Such reliance is misplaced since, as the Court of Appeals for the Second Circuit has recognized in a more recent decision, mere approval of a transaction by the directors is insufficient to excuse demand. *Lewis* v. *Graves,* ____F.2d____, [Current] CCH Fed. Sec. L. Rep. ¶ 99,106 at 95,281 (2d Cir., Feb. 28, 1983); see also *Grossman* v. *Johnson, supra,* 674 F.2d at 124; *Lewis* v. *Curtis,* 671 F.2d 779, 785 (3d Cir.), *cert. denied,* ____U.S.____, 103 S. Ct. 176 (1982); *Greenspun* v. *Del E. Webb Corp.,* 634 F.2d 1204, 1210 (9th Cir. 1980).

guendo) the merits of the claim of excessive compensation, the independent and disinterested directors still have a substantial role. Surely, their decision to side with the complainant (entirely or in part) would have important consequences, and even their knowledgeable disagreement with the demand might be deemed worthy by the court of grave consideration under § 36(b)(2)."

Moreover, both the Court of Appeals in this case and Judge Gibbons in his dissenting opinion in *Weiss* erred in viewing the business judgment rule and the director demand requirement as necessarily governed by the same standard so that either both must apply or neither applies. In fact, although the principle of corporate self-governance underlies both, the business judgment rule and the director demand requirement involve different considerations and their applicability is not necessarily coincidental. *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 940-42; *Heit* v. *Baird, supra,* 567 F.2d at 1162-63 n.6. As the American Law Institute stated in its proposed Restatement of Principles of Corporate Governance and Structure § 7.02 at 270-71 (Tent. Draft No. 1, 1982):

> "It is not inconsistent for a court to employ a strict standard with respect to the excusal of demand, but then to refuse to accept a decision by the same board of directors to seek termination of the same action. . . . As some decisions have emphasized, the focus at the demand stage should be on the issue of whether the corporation may take over the suit and either prosecute it or adopt other internal corrective measures, and not on the later question of whether a decision not to sue should be respected by the court.

> At the demand stage, the possibility should not be foreclosed that a demand will induce the board to consider issues and crystalize policies which otherwise might not be given attention (e.g.,new accounting controls, revised corporate policy statements or even a change in personnel or remuneration). The demand rule can have efficacy even where the board ultimately rejects the action and the court ultimately permits the plaintiff to sue."

In sum, the director demand requirement is applicable regardless of whether the directors of an investment company can cut off a § 36(b) action. Indeed, as the Court of Appeals for the Third Circuit concluded in *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 942:

> "The opportunity to resolve the shareholder grievance without resort to litigation may, in fact, be especially important if the directors are not able to terminate the suit. In that event the Rule 23.1 demand provides the only opportunity for the Fund to avert a lawsuit through internal corrective measures."

B. The one-year limitation on recovery in § 36(b) actions does not make the director demand requirement inapplicable

As a final reason for exempting § 36(b) actions from the director demand requirement, the Court of Appeals below relied on the fact that § 36(b) limits recovery to excessive fees paid up to one year before commencement of the action and that the delay caused by the directors' consideration of a demand might preclude full recovery. *Fox* v. *Reich & Tang, Inc., supra,* 692 F.2d at 261-62. This contention is without merit.

The Courts of Appeals for the First and Third Circuits have well stated why the one-year limitation on recovery should have no bearing on the applicability of the director demand requirement to § 36(b) actions. In *Grossman* v. *Johnson, supra,* 674 F.2d at 122, the Court of Appeals for the First Circuit held:

> "Lastly, plaintiff invokes the short one-year limitation period on damages as sufficient reason for exempting § 36(b) cases from the demand provision of Rule 23.1—the time taken by demand-and-response before institution of an action would, it is argued, diminish the period and the amount of recovery. The truth is, however, that ordinarily the demand requirement could change the particular one-year period for which recovery was allowable but would not reduce the one-year recovery period, and probably not decrease the amount. In the unusual case in which the amount of recovery could actually be reduced by directors' dawdling or the taking of excessive time to reply to a demand, a district court could allow suit to go forward without awaiting a response. See *Mills* v. *Esmark, Inc.*, 91 F.R.D. 70, 73 (N.D. Ill. 1981)." (footnotes omitted)

Similarly, in *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 938, the Court of Appeals for the Third Circuit held:

> "We recognize that in some cases, demand will postpone the filing of suit and thereby move forward the one-year period allowed for the recovery of fees. In most instances, however, this will not reduce the allowable recovery. In any event, we do not see why demand cannot be promptly made and expeditiously considered. Notwithstanding Weiss' intimations to

the contrary, demand is a simple procedure that is not burdensome to the shareholders. We therefore do not believe that the one-year limitation period compels the conclusion that Congress intended to eliminate the demand requirement." (footnote omitted)

Thus, there is nothing in the one-year limitation on recovery which is inconsistent with or which demonstrates a Congressional intent to exempt § 36(b) actions from compliance with the director demand requirement of Rule 23.1.

Conclusion

The judgment of the Court of Appeals should be reversed, and the Complaint should be dismissed.

Respectfully submitted,

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April 21, 1983

No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. and REICH & TANG, INC.,

Petitioners,

—v.—

MARTIN FOX,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENT'S BRIEF

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Question Presented for Review

Is demand upon the directors of an investment company a prerequisite to the commencement of a security holder's action for excessive compensation under § 36(b) of the Investment Company Act?

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RESPONDENT'S BRIEF

Statement of the Case

Respondent, a shareholder of Daily Income Fund, Inc. (the "Fund"), brought this action to recover excessive advisory fees paid by the Fund to its investment adviser, Reich & Tang, Inc. ("R&T"). The Fund, commonly known as a money market fund, invests in a portfolio of short-term money-market instruments such as United States Government and federal agency obligations, certificates of deposit of major banks, and prime commercial paper. For the routine services involved in selecting money-market instruments, R&T's advisory fee was set at one-half of 1% of the Fund's net assets.

During the less than three years preceding the filing of the complaint the Fund experienced a dramatic growth in

assets. As of June 30, 1978, the Fund's net assets were approximately $75 million. By April 15, 1981 they had reached a level of $775 million. Despite this tremendous increase in Fund assets, no adjustment was made in the formula by which R&T was paid for investment advice. The yearly payments to R&T thus increased from approximately $375,000 to $3,875,000. Respondent's complaint alleges that, in light of the facts under which these fees have been received, their receipt constitutes a breach of fiduciary duty under § 36(b) of the Investment Company Act (15 U.S.C. § 80a-35(b)), which authorizes shareholders to sue for excessive advisory fees.

Eight weeks after the commencement of the action, the petitioners moved to dismiss the complaint for failure to make demand upon directors. Plaintiff contended that under § 36(b) of the Act no such demand is required, but that if the court felt otherwise it should grant plaintiff leave to file an amended complaint to afford him time to make the demand and to give the directors time to make a response. The Fund, which had based its motion upon *Markowitz* v. *Brody*, 90 F.R.D. 542 (S.D.N.Y. 1981), sanctioning such a procedure, expressly acquiesced in plaintiff's request.

The district court held the motion *sub judice* for eight months and then granted it, holding that a pre-complaint demand is required. It refused to grant plaintiff leave to file an amended complaint.

The Court of Appeals for the Second Circuit reversed the district court. The Court of Appeals made a comprehensive examination of Congressional intent in enacting § 36(b) of the Investment Company Act. It found that Congress was concerned with the level of advisory fees charged to investment companies; that investment company directors had been ineffective in reducing advisory fees

and could not be expected to secure such reductions; that Congress intended to provide effective means for the courts to act; that those effective means were entrusted to shareholders and the SEC; and that consequently, Congress did not intend to create a right of action by the investment company itself.

Since the investment company does not itself have a right of action, the court held, no demand is required on the directors. The court noted that this conclusion is reinforced by this Court's statement in *Burks v. Lasker*, 441 U.S. 471, 484 (1979), that Congress intended in § 36(b) to prevent board action from cutting off shareholder suits. It also found support for its conclusion in the short one-year statute of limitations contained in § 36(b), which would eliminate a substantial portion of the recovery if demand procedures were required to be observed.

Summary of Argument

Congress enacted § 36(b) to control excessive advisory fees. Investment company directors had been ineffective in securing fee reductions. Congress therefore gave the power of enforcement to security holders and to the Securities and Exchange Commission.

Since the investment company itself has no right of action under § 36(b), the security holder bringing a suit for excessive compensation is not required to make a demand upon the board of directors. Moreover, even if the investment company could sue, the very wording of the statute and the intent behind it provides the fund shareholder with a right to maintain an action that cannot be obstructed by any fancied need to request action by those whose very inaction gave rise to the legislation.

ARGUMENT

POINT I

An Investment Company Has No Right of Action Under Section 36(b).

A. *The Statutory Language.*

Section 36(b) of the Investment Company Act, added in 1970, provides that any security holder of an investment company, or the Securities and Exchange Commission, may bring an action to recover damages for the investment company for excessive compensation paid to the investment company's investment adviser. The section does not create a right of action which may be brought by the investment company itself.

The uncontested starting point for determining whether the statute impliedly confers the right to sue upon the corporation is examination of the actual language utilized by Congress; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976). Section 36(b), specifying who may bring actions for excessive compensation, designates only the Securities and Exchange Commission or a security holder of a registered investment company.

This is not, thus, the typical stockholder's derivative action. The typical action is brought where the corporation has a right, created by statute or otherwise, which the directors do not enforce. Rights which enure to corporations are created by thousands of statutes, state and federal; there is no need to expressly provide for a shareholder's derivative action, for if the directors improperly fail to pursue the corporate benefits, a shareholder may sue derivatively. Thus, when Congress creates a right of action that, by the express terms of the statute, may be asserted directly by a security holder and not by the cor-

poration, it must be presumed to intend something other than the usual means of derivative procedures for enforcement.

These considerations, pertinent to shareholder actions, coincide with broader principles enunciated by this Court to support the conclusion that the statute does not create a right of action in the corporation. This Court has consistently refused to imply rights of action where express statutory provisions for other forms of proceeding are provided by Congress. Thus, in *S.I.P.C.* v. *Barbour*, 421 U.S. 412, 419 (1975), the Court stated ". . . express statutory provision for one form of proceeding ordinarily implies that no other means of enforcement was intended by the Legislature." The culmination of this line of cases, of which a sampling is set forth in the margin,[1] was stated by the Court in *Middlesex County Sewerage Authority* v. *National Sea Clammers Association*, 453 U.S. 1, 101 S.Ct. 2615 (1981), cited approvingly by both the majority and the dissent in *Merrill Lynch Pierce Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353, 102 S.Ct. 1825, 1839; dissent pp. 1848, 1849, 1853 (1982). In that case, Congress had provided statutory remedies to government officials and private citizens, just as under § 36(b) Congress entrusted enforcement to the SEC and to security holders of investment companies. This Court took special note of these provisions. It stated:

> "These Acts contain unusually elaborate enforcement provisions, conferring authority to sue for this

[1] *Touche Ross & Co.* v. *Redington*, 442 U.S. 560 (1979); *Cannon* v. *University of Chicago*, 441 U.S. 677 (1979); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11 (1979); *Universities Research Association, Inc.* v. *Coutu*, 450 U.S. 754 (1981); *Northwest Airlines, Inc.* v. *Transport Workers Union*, 451 U.S. 77 (1981); *California* v. *Sierra Club*, 451 U.S. 287 (1981); *Texas Industries, Inc.* v. *Radcliff Materials*, 451 U.S. 630 (1981).

purpose both on government officials and private citizens. . . .

In view of these elaborate enforcement provisions it cannot be assumed that Congress intended to authorize by implication additional judicial remedies . . . As we stated in *Transamerica Mortgage Advisers, supra,* 'it is an elemental canon of statutory construction that where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it.' . . . In the absence of strong indicia of a contrary congressional intent, we are compelled to conclude that Congress provided precisely the remedies it considered appropriate." (101 S.Ct. at 2623).

Reinforcing this reading of the statute is the fact that the Investment Company Act is a comprehensive legislative scheme to regulate the operation of investment companies. In *Texas Industries, Inc.* v. *Radcliff Materials*, 451 U.S. 630, 101 S.Ct. 2061 (1981), this Court refused to imply a right of contribution in the Sherman Act (101 S.Ct. at 2069):

"'The presumption that a remedy was deliberately omitted from a statute is strongest when Congress has enacted a comprehensive legislative scheme including an integrated system of procedures for enforcement.' *Northwest Airlines, Inc.* v. *Transport Workers Union, supra,* —— U.S. —— at ——, 101 S.Ct. at 1584."

". . . There is nothing in the statute itself, in its legislative history, or in the overall regulatory scheme to suggest that Congress intended courts to have the power to alter or supplement the remedies enacted."

Section 36(b) is indeed a "comprehensive legislative scheme including an integrated system of procedures for enforcement." It creates a new cause of action for recovery of unreasonable advisory fees which obviates the necessity of proving personal misconduct on the part of any defendant. It reflects congressional dissatisfaction with the ability of investment company directors to obtain appropriate redress. It confers the power to sue on the SEC and security holders.

As recognized in *Boyko v. The Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y. 1975), ". . . nowhere in the legislative history of Section 36(b) does an action by the directors of the Fund seem to be contemplated." *Id.* at 695. In that connection, the court stated:

> "This omission was apparently not the result of Congressional oversight. The legislative history of the amendment is relatively comprehensive, and the amendments themselves were enacted in the Senate only after a three-year period of extensive committee hearings and executive sessions on the subject matter."

See also, *Blatt v. Dean Witter Reynolds Intercapital, Inc.*, 528 F.Supp. 1152, 1155 (S.D.N.Y. 1982) (". . . nor does the statute provide directors the right to institute suit . . .").

B. *The Legislative History.*

The legislative history of § 36(b) clearly demonstrates Congress' intention to vest the right to bring suit in security holders and the SEC and thereby avoid the necessity of requesting action from the board of directors. The statute was designed to provide a meaningful remedy for excessive advisory fees charged to investment companies. Those fees had grown to substantial proportions. The prevalent structure of investment companies had (and has

today) the unusual feature of external management, *i.e.*, the investment advice and management of most investment companies is provided by an organization not subject to the direct control of the board of directors.

Significant among the indications of Congress' intent to authorize security holders rather than directors to bring suit is its rejection of a bill proposed by the Investment Company Institute ("ICI") which would have vested the right to bring action in the investment company itself. When the legislation was pending before Congress the ICI proposed an amendment which, with respect to actions for excessive compensation, would have provided:

> "Such actions may be brought only *by the company* or a security holder thereof on its behalf and only in an appropriate District Court of the United States."

Hearings on S.1659 Before the Committee on Banking and Currency, United States Senate, 90th Cong. 1st Sess., p. 101 (1967) (emphasis supplied).[3] SEC Chairman Manuel F. Cohen strongly opposed the proposed ICI alternative and, while his comments were directed at numerous aspects of the ICI's proposal, he clearly stated his opposition to any alternative which would "hamstring the courts" in examining the fairness of advisory fees:

> "Thus, the industry has not provided any effective means of enforcing the standard of reasonableness. . . . We see no reason why a fiduciary who has received unreasonable fees should be allowed to retain the unreasonable portion of his fee merely because the unaffiliated directors were unable to do anything about the situation. The inability of the unaffiliated directors

[3] Hereafter "1967 Senate Hearings".

freely to exercise their business judgment and negotiate a reasonable fee is the very reason why judicial protection is necessary."

Id., p. 96.[3]

[3] Throughout the Congressional hearings the SEC consistently took the position that the independent directors were ineffective in securing reduction of advisory fees and that court review of management fees is required to protect the interests of fund shareholders. See, for example, *id.* pp. 1193-94, 1199, 1200 (interpolation supplied; emphasis in original):

> "The plain fact which emerges from our studies and these hearings is that in a significant number of cases mutual fund advisory fees are excessive."
>
> * * * * *
>
> "The 'unaffiliated' directors have not been able to act effectively to protect the shareholders' interests in relation to the fees. In many instances, the mechanical one-half of one percent advisory fee rate set in the 1930's has not been modified appreciably."
>
> * * * * *
>
> "In the future, lawyers will make certain that prescribed rituals are followed, and that the minutes of directors meetings contain all the necessary recitals, but real bargaining and effective control of the negotiation process will still be impossible. Most fund boards presently contain a majority of unaffiliated directors—with no discernible results in the fee area."
>
> * * * * *
>
> "On balance the 'unaffiliated' or independent director provided for in the statute as a protection for public shareholders really serves as insulation for the adviser in his operation of the fund. Approval of the advisory contract by the unaffiliated directors creates an appearance of an independent 'watch-dog' over the affiliated directors. This appearance rarely reflects the reality. The few cases where independent directors have asserted themselves do not change the total picture, nor does it mean that we should be optimistic about their possible future effectiveness. Nor should this Commission view the strengthening or adding to the required number of unaffiliated directors as a reasonable alternative to the solution we have proposed in our Bill."
>
> * * * * *
>
> ***"Court Review of Management Fees is Necessary."***

Congress rejected the alternative proposed by the ICI and provided that excessive compensation actions could be brought only by the SEC or security holders.

Moreover, the legislative history overwhelmingly demonstrates Congressional intent to give effective means to security holders to take action against excessive investment advisory fees. The bill was predicated, as the Senate Committee Report states (Report of the Senate Committee on Banking and Currency No. 91-184, 91st Congress, 1st Sess. pp. 1-2), on the Securities and Exchange Commission's findings in its 1966 Report on Investment Companies. That Report, entitled "Public Policy Implications of Investment Company Growth" ("PPI") (House Report No. 2337, 89th Congress, 2d Sess.) stated:

> "It has been the Commission's experience in the administration of the Act that in general the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry." (p. 131)

* * * * *

> "Absent express recognition of the duty to charge reasonable fees in the area of management compensation, the means provided in the Act for the enforcement of that duty in this area are unclear and inappropriate. . . . In the Commission's views, section 36 should be broadly construed so as to effectuate the remedial purposes of the Act." (p. 143)

* * * * *

> "The analysis of the shareholder fee litigation not only underscores the need for changes in existing statutory provisions relating to management compensation in the investment company industry, but points to the direction which these changes should take. It makes

clear the need to incorporate into the Act a clearly expressed and readily enforceable standard that would measure the fairness of compensation paid by investment companies for services furnished by those who occupy a fiduciary relationship to such companies." (p. 143)

* * * * *

"The right of the Commission as well as investment company shareholders to take action against violations of the statutory standard of reasonableness is essential to effective enforcement." (p. 146)

* * * * *

"The unaffiliated directors, as the only potentially disinterested persons in the manageemnt of most investment companies, can and should play an active role in representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders. But even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation." (p. 148)

Congress was also aware that, in contrast to many industrial companies, in almost every case investment companies had then (and have now) a majority of unaffiliated directors. Mr. Joseph E. Welch, Chairman of the Federal Legislative Committee of the ICI, so testified:

"In actual fact, almost all of the funds have a majority of independent directors, or unaffiliated directors, on their boards. This occurs because quite often the investment manager and the underwriter are the same entity or related entities, and there is a provision in the act which requires that a majority of the fund board be unaffiliated with the fund underwriter." (1967 Senate Hearings, p. 194)

Given a majority of unaffiliated directors, the traditional excuses justifying failure to make demand would ordinarily be inapplicable in the absence of a showing of self-interest or bias. Petitioners' contentions thus imply that Congress spent three years in creating a remedy which it knew would be practically unenforceable. But, of course, it had no such intention. Congress, the SEC and even the ICI fully expected that enforcement of the constraints against excessive compensation would be by security holders and the SEC, and not by the investment company. See, *e.g.*, 1967 Senate Hearings, pp. 272-73.

Indeed, if Congress had any notions that the directors would be effective in securing relief, the SEC and many other witnesses reepatedly disabused them of the notion. As SEC Chairman Manuel F. Cohen testified:

"Senator Williams: Have the unaffiliated directors ever upset the regular directors' applecart?

Mr. Cohen: I have never heard of it in my 25-odd years in association with these funds." (Id., p. 81)

See aso Hearings Before the Senate Committee on Banking and Currency on S.34 and S.296, pp. 168-69 (1969) ("1969 Senate Hearings"); 1967 Senate Hearings, p. 710.

The Senate Committee Report left no doubt of the desirability of stockholder access to the courts (Report of

the Committee on Banking and Currency, Senate Report No. 91-184, 91st Cong., 1st Sess., p.2 (1969)):

> "In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty."

And see id., pp. 6-7:

> ". . . the ultimate responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court . . .
>
> * * * * *
>
> ". . . this section is designed to . . . provide a means by which the Federal Courts can effectively enforce the federally-created fiduciary duty with respect to management compensation."

The petitioners are able to point to only two aspects of the legislative history, neither of which supports their contention. First, they point to a portion of the Senate Report which indicates an intention to strengthen the role of unaffiliated directors within the corporation (Petitioners' Br., p. 6). To be sure, Congress did intend to strengthen the role of disinterested directors. But if there is any inconsistency between this intention and the provision enabling security holders to sue directly, it is one mandated by Congress. Petitioners' judicial authority for the

general proposition of directorial responsibility under the Act—*Burks* v. *Lasker*, 441 U.S. 471 (1979)—singles out § 36(b) as preventing board action from cutting off shareholder suits.

Their other reliance is placed upon two statements by SEC Chairman Budge (Chairman Cohen's successor) that the Federal Rules of Civil Procedure provide safeguards to prevent unjustified shareholder litigation. (Petitioners' Br., p. 8). Apart from the fact that the quotations from Chairman Budge are taken completely out of context,[4] the petitioners' effort to garner support from Chairman Budge's testimony is based upon an attempted alteration of his actual remarks. Chairman Budge in referring to safeguards in the Federal Rules of Civil Procedure cited as an example Rule 23.[5] Petitioners ask the Court to believe that Mr. Budge intended to refer to Rule 23.1 rather than Rule 23 and from this they ask the Court to infer that Mr. Budge had in mind the demand requirement which is a part of Rule 23.1, although it does not exist in Rule 23.

In fact, however, there is no reason to suppose that Chairman Budge intended anything other than what he said.

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[4] Chairman Budge was addressing a proposal that a shareholder would have to wait six months after requesting Commission action before he could bring his own suit. He objected to the provision, noting that the Commission had taken the position that the interposition of procedural obstacles should not be applied in litigation involving allegations under the Investment Company Act. He went on to state that the spectre of shareholder actions flooding the courts with harassing law suits is a much overworked boogeyman which should not deter the Congress from passing the legislation, and that shareholder actions had played an important role in protecting shareholders from insiders who are willing to betray their company's interest in order to enrich themselves. Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 91st Cong., 1st sess., pp. 201-2, 860 (1969) ("1969 House Hearings").

[5] Id., at p. 860.

The court below noted that a § 36(b) action is not strictly speaking a derivative action, and, although the petitioners and the ICI as *amicus* take issue with this statement, there is ample support for the Court of Appeals, and, by the same token, for Chairman Budge's view.[6]

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[6] Section 36(b) is similar to § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) in providing expressly for an action by a security holder. The courts in construing § 16(b) have noted

> "The statute here involved creates a new cause of action, which, while similar in some respects to a secondary or derivative right, is not such a right at all. It is in reality a primary right. This is so because the statute which creates it makes it so."

Dottenheim v. *Murchison*, 227 F.2d 737, 738 (5th Cir. 1955), *cert. denied*, 351 U.S. 919 (1956); see also *Benisch* v. *Cameron*, 81 F.Supp. 882, 884 (S.D.N.Y. 1948); *Pellegrino* v. *Nesbit*, 203 F.2d 463, 466 (9th Cir. 1953); *Blau* v. *Oppenheim*, 250 F.Supp. 881, 883 (S.D.N.Y. 1966); *Blau* v. *Albert*, 157 F.Supp. 816, 818 (S.D.N.Y. 1957).

Legal commentary also supports this analysis:

> "While there is a superficial similarity between Section 16(b) suits and the ordinary shareholders' derivative actions, it is indicated clearly on the face of Section 16(b) that it has a broader reach than such derivative suits in a number of important aspects. Its fundamental purpose, moreover, is to make disgorging of insiders' profits almost automatic. Hence, those limitations that have been developed in respect to derivative suits, because many of them have been found to be unmeritorious, ought not to apply in the present context . . . . The security holder plaintiff in a Section 16(b) action, in addition to seeking recovery for the benefit of all present security holders as in the ordinary derivative suit, acts as an instrument of a statutory policy against short-term insider trading. As such, a defense addressed to the fact that he may have purchased his securities to qualify as a party to the action and is not aggrieved should be unavailable. A Section 16(b) suit differs from a stockholder's derivative action in that it is founded upon a specific statute enacted to remedy an existing evil." Ruben and Feldman, Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders, 95 U. of Penn. Law Review, 468, 473, 474 (1947).

At least one commentator, the author of this brief, pointed out the similarity between § 16(b) and § 36(b) prior to the latter's

The correctness of Chairman Budge's reference to Rule 23 can be ascertained by reviewing the remarks of the advisory committee which proposed Rule 23 in 1966. The advisory committee noted that subdivision (b)(1)(B) of Rule 23 would apply ". . . to an action which charges a breach of trust by an indenture trustee or other fiduciary similarly affecting the members of a large class of security holders or other beneficiaries, and which requires an accounting or like measures to restore the subject of the trust." 39 F.R.D. 69, 101 (1966). And the cases relied upon by the advisory committee involve, *inter alia,* claims for excessive compensation; in short, the very prototype of a § 36(b) action. It is thus perfectly logical to assume that Chairman Budge meant what he said; that he intended to rely on Rule 23, which, of course, has no requirement for directorial demand; and that Congress so understood him.

The ICI as *amicus* contends that the legislative history of § 36(b) discloses a pervasive concern with "strike suits." (ICI Br., pp. 19-20). As we have seen before (p. 14, n.4, *supra*), most of these quotations are taken out of context. But more importantly, where there was expression of some concern about unjustified law suits, the recommended solu-

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passage; Meyer, *The Legislative Impact on Advisory Fees,* Mutual Funds, 303, 335 (PLI 1970).

See also 2 Frankel, *The Regulation of Money Managers* 282 (1978):

> ". . . By analogy to judicial interpretation of section 16(b) of the 1934 Act, it could be argued that rules of procedure cannot abrogate an express right of action in the Act."

The ICI contends that the legislative history describes § 36(b) as a derivative action. (ICI Br., p. 19n. 43, and accompanying text). The references in the legislative history, however, were to suits under prior law or general allusions to derivative and shareholder litigation. See, for example, the reference by Congressman Blanton to then existing actions against officers and directors; 116 Cong. Rec. 33,286 (1970).

tions did not include subjecting plaintiff shareholders to demand procedures. Thus, for example, Judge Friendly, upon whom the ICI relies, stated:

> "There remains the claim that § 15(d) [later § 36(b)] would be a litigation breeder. But it is not a valid objection that a statute may lead to the bringing of lawsuits; what would matter would be unjustified lawsuits. While some derivative actions are brought simply for harrassment, we have become increasingly aware that others serve a most useful purpose in policing directors and officials who otherwise would be laws unto themselves. Indeed we have the highest authority for this proposition. The Supreme Court has said, in a not unrelated context, that 'Private enforcement of the proxy rules' through actions by stockholders 'provides a necessary supplement to Commission action' in view of the limited resources available to the SEC, and has analogized this to the role of the private treble damage suit in the enforcement of the antitrust laws. J.I. Case Co. v. Borak, 377 U.S. 426, 432-33 (1964).
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> "There are a good many safeguards against unjustified suits under § 15(d). First of all, the funds are given a year to bring their houses into what they conceive to be order, § 28(1). They would be well advised to reduce advisory fees at least to the level marked out by settlements in the suits brought under existing law. Funds that had not done this, particularly large ones, would be the prime targets for private actions. Although suits might be brought against others, I suspect the plaintiffs would be content to leave these on the back burner while the suits against the more vulnerable funds progressed to settlement of judgment. Once a half dozen actions had been decided by appellate courts, most funds would bring themselves info a

position where they would no longer be attractive objects for suit. I put it that way because the economies are such that private actions will not be prosecuted unless there is a strong probability of success; lawyers will not wish to spend years litigating against well-financed defendants unless there are real prospects of financial reward." 1967 Senate Hearings, pp. 1016-17 (interpolation supplied).

Of even greater importance is the action taken by the House of Representatives. The House did have some concern about unjustified law suits. However, it proposed to deal with the issue not by imposing a demand requirement, but by requiring that the shareholder be a *bona fide* shareholder acting in good faith and with justifiable cause and that he prove his case by clear and convincing evidence. Thus, the House Report, H.R. Report No. 91-1382, 91st Cong. 2d Sess. (1970), stated (pp. 7-8):

> "The new section 36(b) added by the reported bill is basically the same as that which would be added by the Senate bill with two exceptions. First, the reported bill specifically requires that the shareholder bringing an action for breach of fiduciary duty be a 'bona fide shareholder' and be 'acting in good faith and with justifiable cause.' This is intended, not as a substantive change, but as a clarification of the fact that the courts should only entertain such actions by bona fide shareholders who are acting in good faith. Secondly, the reported bill requires that the plaintiff in an action under section 36(b) shall have the burden of proving the breach of fiduciary duty by clear and convincing evidence. This increased burden of proof was added by your committee to prevent the harassment of investment advisers by ill-founded and nuisance law suits, the so-called strike suit. It is not

> intended to hamper the well-founded law suit, and it is not intended to negative the traditional concept of fiduciary duty."

The House, however, receded from its proposal and accepted the Senate version without extended comment. Conference Report, p. 30 (H. Report No. 91-1631, 91st Cong. 2d Sess. (1970)).

Notwithstanding the language of the statute and the overwhelming legislative history, both of which combine to mandate direct stockholder actions, the petitioners contend that the investment company has its own right of action under § 36(b). Such a right of action, they say, should be implied because, at the time of the 1970 Amendments to the Act, Congress knew that an investment company had its own right of action against its adviser and merely intended to continue this well-established right. (Petitioners' Br., pp. 10-12). Petitioners' principal reliance is upon *Merrill Lynch, Pierce Fenner & Smith* v. *Curran*, 456 U.S. 353, 102 S.Ct. 1825, 1839 (1982).

Curran, however, is quite to the contrary. In *Curran* this Court was asked to determine whether previously implied rights of action under the Commodity Exchange Act survived or would be rejected as a result of the 1974 amendments to that statute which had made substantial changes in the statutory scheme, including the addition of new satutory remedies, but which had left intact the provisions under which the courts had previously implied rights of action. This Court held that, since Congress was aware of the earlier judicially implied rights of action and expressed no desire to eliminate them, one could infer that by not repealing the implied rights Congress intended to retain them.

Section 36(b), on the other hand, was newly codified by the 1970 amendments. It created a totally new cause of action with carefully crafted standards and a very short statute of limitations. It imposes liability without personal misconduct. It limits recovery to the actual recipients of the excessive compenstaion. There was no previous judicial record recognizing implied rights of action under section 36(b) prior to the 1970 amendments because it did not yet exist. *Curran,* therefore, offers no assistance to this Court in discovering an implied right of action under a new section creating a limited new cause of action, and is, indeed, to the contrary.

Indeed, counsel of record for the petitioners proclaimed the uniqueness of § 36(b) to this Court in 1978. At that time he stated

> "Section 36(b) was enacted into law by Congress in 1970 as an amendment to the Investment Company Act of 1940—it is a unique and highly specific section dealing solely with the compensation of investment advisers. Section 36(b) *expressly* created a right of action by a shareholder of a mutual fund against the investment adviser for breach of fiduciary duty with respect to investment advisory fees, irrespective of whether the disinterested directors have, in the exercise of their business judgment, approved those fees.
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> * * * * *
>
> "In short, the subject of investment adviser compensation covered by Section 36(b) is *sui generis.*"

Petitioners' Brief in *Burks* v. *Lasker,* No. 77-1724, pp. 27-28 (emphasis in original).

Section 36(b) is thus not, as petitioners contend, an extension of the shareholders' common law action for cor-

porate waste (Petitioners' Br., p. 10). Nor does the Fund, as the ICI contends (ICI Br., p. 14), have an identical cause of action under Maryland law for excessive advisory fees, which, according to the ICI, the Fund is not precluded from asserting. Section 36(b) constitutes the exclusive remedy against an investment adviser for excessive advisory compensation; not involving personal misconduct; *Fogel* v. *Chestnutt*, 668 F.2d 100, 112 (2d Cir. 1981), *cert. denied*, —— U.S. ——, 103 S.Ct. 65 (1982); *Halligan* v. *Standard & Poor's/Intercapital, Inc.*, 434 F. Supp. 1082, 1084 (E.D.N.Y. 1977); and Subdivision 5 of § 36(b) requires that the action be brought in a federal district court.[7]

[7] Implied rights of action under the Act were recognized by the courts before the 1970 amendments under previously enacted sections of the Act prohibiting waste, conversion, gross misconduct, etc. (*Esplin* v. *Hirschi*, 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969); *Levitt* v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Taussig* v. *Wellington Fund, Inc.*, 313 F.2d 472 (3d Cir.), *cert. denied*, 374 U.S. 806 (1963); *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961). Such implied rights of action were found under sections 15, old 36 (which became 36(a) in the 1970 amendments), 37 and 48, in light of *Curran*, would appear to continue with the same vitality after the 1970 amendments. *Fogel* v. *Chestnutt*, *supra*; *Jerozal* v. *Cash Reserve Management, Inc.*, *Fed.Sec.L.Rep.* (CCH) ¶ 99,019 (S.D.N.Y. Aug. 10, 1982). The existence of these implied rights of action before the 1970 amendments should not, however, cause the courts to imply a new right of action under section 36(b).

POINT II

Under Section 36(b) of the Investment Company Act Demand Upon Directors to Institute the Action Is Not Required.

In the previous Point we have shown that an investment company does not have a right of action under § 36(b). Since it has no right of action, demand upon the directors to institute such an action is required neither by Rule 23.1 F.R.C.P. nor by the dictates of common sense. Moreover, even if the investment company did have a right of action, the statutory specification of security holders as persons entitled to bring such actions obviates whatever necessity might otherwise exist for requesting action by the directors.

A. *The Absence of a Right of a Corporation to Sue Renders Inapplicable Any Requirement to Make a Demand on the Directors.*

By its terms Rule 23.1 F.R.C.P. applies only to those situations where a corporation fails "to enforce a right which may properly be asserted by it." The inapplicability of the demand requirement where the corporation is powerless to bring suit is so manifestly self-evident that it cannot seriously be questioned. But the Petitioners do.

Petitioners' first argument is that, even without a claim under § 36(b), the corporation has a valid claim under state law against its investment adviser to recover excessive fees. (Petitioners' Br., pp. 15-16). As we have shown above, however (p. 21), § 36(b) is the exclusive remedy for recovering excessive advisory fees. The prescription of the explicit and detailed federal standard necessarily requires uniform federal interpretation, *Burks* v. *Lasker*, 441 U.S. 471, 479 n.6 (1979), and preempts the field; *De-Rencis* v. *Levy*, 297 F.Supp. 998 (S.D.N.Y. 1969).

Of course, even if the investment company had an action for corporate waste under the common law, this would hardly justify a demand requirement in a § 36(b) action. Under § 36(b) a shareholder is entitled to recover on behalf of the company if he can prove a breach of fiduciary duty with respect to the receipt of advisory fees. He is not required to prove personal misconduct, and it would be a subversion of the purpose of the Act to relegate him to forego the standards of § 36(b) and await the outcome of an action for common law waste of assets. It was precisely because Congress "decided that the standard of 'corporate waste' is unduly restrictive and recommends that it be changed" that § 36(b) was enacted; Report of the Senate Committee on Banking and Currency to Accompany S. 2224, S. Rep. No. 91-184, 91st Cong. 1st sess., p. 5 (1969).

Petitioners contend that demand is useful because it gives the directors an opportunity to obtain redress short of litigation. However, Congress in enacting § 36(b) did so in large part because it felt that directorial action was ineffective in the investment company sphere:

> "Because of the uniqne structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arms-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the

American economy." Sen. Rep. No. 91-184, 91st Cong., 1st Sess., p. 5 (1969).

The court below dealt squarely with the Petitioners' contentions:

> "As indicated, we disagree that availability of informal methods of attempting to recoup excessive adviser fees is sufficient to trigger the demand requirement of Rule 23.1. Moreover, we find the examples given by the Fund—negotiating with the Adviser to obtain a refund, and terminating the contract, Brief for Defendant-Appellee Daily Income Fund, Inc. at 5-6—not persuasive. Negotiations may well fail, and termination of the contract, although perhaps depriving the adviser of future business, may not effect the remedy sought by the shareholder plaintiff, which is the return of excessive fees. Additionally, 'a mutual fund cannot, as a practical matter sever its relationship with [its] adviser.' S.Rep. 184, 91st Cong., 1st Sess. 5 1969), *reprinted in* 1970 U.S. Code Cong. & Ad. News at 4901. Moreover, given the directors' past relationship with the adviser in approving the contract in the first place, 15 U.S.C. § 80a-15(c), the likelihood that negotiations will prove effective is highly speculative. *See Blatt v. Dean Witter Reynolds Intercapital, Inc., supra*, 528 F.Supp. at 1156 (dictum). In reaching this conclusion, we do not ignore the salutary purpose served by requiring complaining shareholders to first 'activate intracorporate remedies,' *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D.Ill. 1981). Rather we conclude that a demand will not be mandated unless, should intracorporate efforts prove insufficient, the corporation itself may bring suit. *Id.* (quoting *Hawes v. Oakland*, 104 U.S. 450, 460-61, 26 L.Ed. 827 (1882))."

F.2d at 254 n.7.

Moreover, imposing a demand requirement for the sole purpose of triggering internal corporate mechanisms, no matter how salutary they may be thought to be, would effectively convert a rule of litigation procedure to a substantive requirement. As such, it would run afoul of the Enabling Act, 28 U.S.C. § 2072. Petitioners contend, relying on *Grossman* v. *Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, —— U.S. ——, 103 S.Ct. 85 (1982), and *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928 (3d Cir. 1982) (petition for cert. pending), that § 36(b) should be harmonized with Rule 23.1 of the Federal Rules of Civil Procedure. However, where a federal rule of civil procedure conflicts with a federal statute it is the rule, not the statute, which must yield; 28 U.S.C. § 2072.

B. *Even if the Corporation Had a Right of Action Under § 36(b), Plaintiff Would Not Be Required to Make a Demand.*

This Court has already considered the Congressional intention in enacting § 36(b) and has held that under that section a security holder's action may not be terminated by a court simply because a board of directors or a committee thereof urge it to do so; *Burks* v. *Lasker*, 441 U.S. 471, 484 (1979):

> ". . . And when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), 84 Stat. 1428, 15 U.S.C. § 80a-35(b)(2), added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to advisor's fees. No similar provision exists for derivative suits of the kind involved in this case." (Footnotes omitted)

The ICI denigrates this Court's statement in *Burks* by referring to it as *dictum* and by criticizing the court's re-

liance on § 36(b)(2), (ICI Br., p. 24n.48). This Court will be the own judge of the importance which it wishes to attach to its prior statements. We think the statement was not *dictum* because it formed an integral part of the rationale. If it be regarded as *dictum*, it is nonetheless carefully considered *dictum*.

The Court's reliance in *Burks* on § 36(b)(2), which instructs the courts to consider the approval given by the directors of a fund to advisory fee compensation, is quite appropriate. The Senate Committee noted that implicit in the requirement to evaluate directorial consideration was the fact that "such consideration would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty." S.Rep. No. 91-184, 91st Cong., 1st Sess., p. 15 (1969). If the directors are unable to make dispositive determinations, a demand upon them is otiose. Thus, § 36(b)(2), as well as § 36(b), compels the conclusion that no demand is required.

The petitioners rely on the holdings in *Grossman* v. *Johnson, supra,* and *Weiss* v. *Temporary Investment Fund, Inc., supra.* But those decisions are weak tea indeed. The First Circuit in *Grossman* acknowledged that a demand requirement in a § 36(b) action "may tend toward the status of a legal vermiform appendix", 674 F.2d at 123, and both cases claimed to divine a difference between terminating litigation and preventing its commencement.

However, there is no logical justification for treating termination of an action differently than the demand requirement. When this Court said that Congress intended "to prevent board action from cutting off derivative suits", it based its holding on a statute which simply provides that a security holder can bring an action. The statute itself refers neither to demand nor to termination. However, the strong implication of the statute and its legis-

lative history is that Congress intended to permit plaintiff shareholders to by-pass the board of directors because mutual fund directors could not be trusted to make an objective decision concerning compensation.

The purpose of a demand is to enable the board of directors to exercise their business judgment. Where, as here, Congress has concluded that directorial judgment is not determinative, a demand is not required. The petitioners' contention that a shareholder must await the outcome of the directors' deliberations is in direct conflict with Congress' findings that "the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates" [8] so that the "responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court." [9]

Moreover, the divided decision of the Third Circuit in *Weiss* conflicts with its decision in *Lewis* v. *Curtis*, 671 F.2d 779, 785-86 (3d Cir. 1982). There, the court stated that the same standards which govern the permissibility of directorial termination also dictate the requirement, or lack thereof, of shareholder demand:

> "There is no reason why a court, in deciding whether a board is sufficiently interested to excuse demand, should not be informed by the same factors used to determine whether a court should defer to the board's decision not to pursue the action."

> ". . . [W]e do not think that we would apply different standards of 'interestedness' to cases in which plaintiff has made no demand and to those in which the demand has been made and rejected."

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[8] H. Rep. No. 2337, 89th Cong.2d Sess., p. 131 (1966).

[9] S.Rep. No. 91-184, 91st Cong.1st Sess., p. 6 (1969).

To the extent that demand and termination may be treated differently, it would appear that principles of state corporate law generally require the plaintiff to make a stronger showing in order to survive a termination motion than to justify the absence of demand. Courts unwilling to dismiss for demand may nevertheless grant termination motions.[10] The corollary suggests that the present posture of the respondent is even stronger than that of the hypothesized terminated plaintiff. Section 36(b) provides shareholder access to the courts, and this Court has held that no board of directors or committee thereof, no matter how pure, may cut off that litigation, unless it be frivolous. The present suit is not frivolous. To extinguish it by the imposition of a procedure not intended by Congress would frustrate the legislative will and the right of investment company shareholders.

[10] Compare *Auerbach* v. *Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994 (1979) with *Barr* v. *Wackman*, 36 N.Y.2d 371, 329 N.E.2d 180 (1975). Virtually all of the cases dealing with dismissals by special litigation committees have arisen in so-called "demand excused" siutations. See, *e.g.*, *Zapata Corp.* v. *Maldonado*, 430 A.2d 779 (Del. 1981); *Lewis* v. *Anderson*, 615 F.2d 778, 780 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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